customers, and in fact demand levels vary widely throughout the country.

The Notice's proposal to use the S&P 400 as a surrogate for the cable industry's "average" rate-of-return is unaccompanied by any analysis concerning its potential relationship to the cable industry. The S&P surrogate ends up being merely a guess at the cable industry's cost-of-capital. The process of becoming more informed on this point is no doubt costly and time-consuming, but it is not a step that can be avoided.

The Part 65 procedures for prescribing telco rates-of-return reflect the difficulty of the task. The rules call for: mandatory data submissions by 80% of the industry, multiple written submission opportunities, discovery, additional evidentiary procedures, including live testimony and cross-examination before an administrative law judge, and under some circumstances, oral argument before the Commission. Because the procedures are so time-consuming, rate-of-return prescriptions are set for two year cycles. In fact, the 1986 prescription was not finalized until after two years of effort, and six notices or orders by the Commission.[47]

The Notice proposes to use the S&P 400 as one shortcut approach to rate-of-return prescription, noting that this measure

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[47] The Commission's rules originally contemplated a represcription every two years with a new proceeding to begin in January of 1988. However, the established schedule was not met and the Commission did not represcribe a new rate until December of 1990.

had been used in the LEC represcription proceeding. However, the S&P 400 was used not as a surrogate for a telco prescription but, rather, as a benchmark to compare actual telephone industry cost-of-equity estimates.[48] The Commission compared the S&P data against specific estimates of the LECs' cost-of-equity. It thoroughly reviewed a number of analyses, including state public utility commission determinations of the cost-of-capital for the RHCs' interstate operations, weighted average cost-of-capital calculations for the RHCs with the cost-of-equity components estimated using each of several "historical" discounted cash flow (DCF) formulas, and several comparable firm studies.[49] Therefore, the S&P 400 was used only as a check on RHC hard data.

In contrast, the Commission has virtually no data specific to the cable industry here. In fact, it is fair to say that the Commission had far more extensive data before it on telephone companies when it first began its represcription proceeding in 1989 than will have at the end of this phase of this proceeding with respect to cable companies. Given this, any industry-wide measure would be arbitrary and capricious. Both legal requirements and common sense dictate an ad hoc approach.

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[48] 1990 Represcription Order, 5 FCC Rcd 7507, 7528 (1990). The main cost-of-capital surrogate was the RHCs' "classic" DCF estimates. Id. at 7527-7529.

[49] Id. at 7508.

C. Individual Companies' Cost-of-Capital Needs to be Adjusted to Reflect Risk of Disallowance.

Industry-wide rates-of-return would be unjustifiable for another reason: The transition to regulation itself has created unique risks. That is nowhere more evident than in this proceeding, where the Commission is proposing to foreclose returns on capital invested to acquire existing systems. TCI has earlier explained why, as a matter of sound policy, equity and constitutional law, the FCC cannot automatically exclude such returns in every instance. Unless the Commission is prepared to rectify this error by in fact allowing return on all acquisition costs, the very act of disallowance (or even the potential for disallowance) itself requires a further adjustment to the systems' allowed rate-of-return to reflect this regulatory risk. See Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).

In Duquesne, the Supreme Court upheld as constitutional a state statute which precluded electric companies from recovering investment in nuclear power plants. It did so, but only upon the well-established analysis of Hope Natural Gas,[50] which requires the courts to look to the "net effect" of the rate regulation to assess its confiscatory nature. Because the ratemaking agency had adjusted the allowed rate-of-return to reflect the regulatory risk of disallowance, the Court found the net effect of the prescribed rates acceptable: "whether a particular rate is 'unjust' or 'unreasonable' will depend to some

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[50] 320 U.S. 591 (1944).

extent on what is a fair rate-of-return given the risks under a particular rate-setting system...." Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989). The Court upheld the result because it reasoned that the agency could have allowed recovery of the investment and concurrently adjusted the allowed rate-of-return on equity downward. The revenue result to the regulated firms under either method, the Court observed, would be the same. Id. at 312.

The same adjustments will need to be made here in accordance with the regulatory risks of disallowance. The Commission may act to allow a return on some or all of "excess" investment made in acquisitions, may permit only a return of some or all of such investment, or may simply disallow any recovery. These risks must be reflected in the rate-of-return prescribed in particular cases, as a matter of constitutional law and, in any event, sound policy.[51]

D. The Commission Should Heed the Experience of Other Rate Regulatory Agencies' Failed Efforts to Establish Industry-Wide Rates-of-Return for Heterogeneous Industries.

Finally, the Commission should heed the experience of other regulatory agencies that have tried unsuccessfully to implement industry-wide unitary rates-of-return. In 1982, the Federal Energy Regulatory Commission ("FERC") set out to implement an industry-wide rate-of-return approach for electric

[51] See Williston Basin Interstate Pipeline Co. v. FERC, 931 F.2d 948, 954 n.6 (D.C. Cir. 1991). See generally, Kolbe & Tye, "The Duquesne Opinion: How Much Hope Is There For Investors In Regulated Firms?" 8 Yale Journal on Regulation 113 (1991).

utilities.[52] The Notice set out a scheme that would divide the electric industry into three classes based on relative risk. FERC proposed to utilize the three generic rates-of-return, unless waived due to "unusual circumstances."[53]

Only two years later, FERC rejected its mandatory unitary rate-of-return proposal and decided instead to calculate generic rates-of-return for the industry on an advisory basis only.[54] FERC explained that a mandatory approach was ill-

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[52] Generic Determination of Rate of Return on Common Equity for Electric Utilities, Notice of Proposed Rulemaking, 47 Fed. Reg. 38332 (August 31, 1982).

[53] Id. at 38337. The main difference between FERC's proposal and the Commission's proposal is that FERC's proposal utilized three risk groups while the Commission offers no such categorization. Actually, FERC contemplated a rate regulatory scheme almost identical to the Commission's proposal -- using one overall rate-of-return for the entire industry -- but this proposal was flatly rejected:

> [FERC] believes [it] would be inappropriate to impose [one overall rate-of-return] on a mature industry comprised of companies with significant differences in both capital structure ratios and embedded costs of debt and preferred stock. Such an approach would likely yield excessive rates of return on common equity for some companies and inadequate ones for other companies.

Generic Determination of Rate of Return on Common Equity for Electric Utilities, 49 Fed. Reg. 29946, 29961 (July 25, 1984).

[54] See id. at 29946. The Commission had hoped that the advisory-only "benchmark" rates-of-return would provide guidance to the parties, serve as a point of departure for FERC, reduce the commitment of staff to duplicative case-by-case approaches, make more accurate and consistent determinations of the cost of common equity, permit the Commission to evaluate the current status of the electric industry, and narrow the focus in individual proceedings from that of common equity to relative risk.

advised, given record evidence that the electric industry was not sufficiently homogenous and that the risk classification system was technically unworkable and unduly burdensome.[55] FERC further announced its plans, beginning 1987, to use the industry-wide rates-of-return as establishing a rebuttable presumption for the allowable rate-of-return for individual electric companies.

FERC annually calculated advisory-only "benchmark" rates-of-return for the electric industry for seven years. During that process, however, FERC decided that it should not apply a "rebuttable presumption" standard to these benchmarks, as it had planned.[56] And in 1992, noting that "the [advisory only generic rate-of-return] benchmark has only rarely been adopted or used in determining the allowed rate-of-return in individual cases,"[57] FERC decided to abandon the generic rate-of-return determinations altogether. FERC found that the anticipated benefits of an advisory-only generic rate-of-return, including the conservation of resources, were never realized:

> [A]nticipated benefits of the benchmark have failed to materialize and the annual benchmark proceedings have not saved resources.... Despite arguments to the contrary, in the Commission's experience, the

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[55] Id. at 29947-29951.

[56] Generic Determination of Rate of Return on Common Equity for Electric Utilities: Final Rule, 52 Fed. Reg. 11 (Jan. 2, 1987). The idea of moving to a "rebuttable presumption" was put off for another year and finally dropped completely. See 53 Fed. Reg. 3342 (Feb. 5, 1988).

[57] Generic Determination of Rate of Return on Common Equity for Electric Utilities: Final Rule, 57 Fed. Reg. 802 (January 9, 1992).

> benchmark has not reduced the parties' uncertainty in rate cases as to what will be the Commission's ultimate determination. Thus hopes of conserving resources and enhanced certainty have not been fulfilled. The Commission's experience also shows that the annual generic benchmark proceedings have not provided the Commission with a significantly better understanding of industry trends, nor provided an appropriate forum to study financial and operating circumstances of the electric utility industry. Moreover, the Commission does not believe that the benchmark provides any special protection to consumers from excessive rates and charges.[58]

The Commission here has the luxury of learning from FERC's past mistakes. The Commission should reject the proposal to develop an industry-wide rate-of-return.

V. THE COMMISSION CANNOT ADOPT GENERIC COSTING RULES.

The Commission's cost accounting proposals to support cost-of-service showings address both issues of cost accounting systems and cost allocation. The Notice further considers, with respect to either allocations among regulated services, and/or allocations between regulated and unregulated services, a "continuum" of possible requirements from franchise-by-franchise accounting to company-wide averaging.[59] Neither industry-wide nor company-wide rules are consistent with the Commission's plan to utilize cost-of-service as a secondary means of regulating cable rates.

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[58] Id. at 805 (footnotes omitted).

[59] Notice at ¶¶ 60-62.

A. Industry-Wide Accounting Rules are Inconsistent with the Safety Net Function Intended for Rate-of-Return Regulation.

It cannot be emphasized sufficiently that the Notice's accounting proposals lose sight of the limited function intended for cost-of-service regulation. At the risk of repetition, TCI underscores that the principal method for regulating cable rates remains benchmarks. The Commission's "competitive benchmark" scheme for cable services does not rely upon costs, and thus traditional issues of regulatory accounting are simply irrelevant for purposes of implementing the regulatory scheme for the majority of cable systems. Only in the unusual cases where a cable operator has been forced to elect cost-of-service showings do these complex concepts come into play. Thus, the Notice's consideration of industry-wide regulation, such as a prescribed Uniform System of Accounts and cost accounting rules, is fundamentally at odds with the secondary, backstop nature of rate-of-return regulation. For this reason, TCI urges the Commission to abandon consideration of this proposal and simply permit a case-by-case showing in accordance with Generally Accepted Accounting Principles.

B. The Commission Lacks Sufficient Data on the Industry to Develop Accounting Rules in this Proceeding.

Even if the use of industry-wide accounting tools were desirable or appropriate, it is not possible for the Commission and the cable industry to develop accurate cost accounting and cost allocation rules in a few months' time. The FCC's experience with telephone regulation demonstrates that cost allocation regulations take decades to develop (sometimes without satisfactory results). The Commission's attempt to adopt accurate cost allocation requirements for the entire cable industry during one notice and comment period is a futile undertaking.

From 1935 until 1988, the Commission utilized a USOA which had been largely scripted by the Interstate Commerce Commission at the turn of the century. For the first three decades its presence was mostly ceremonial; its utility to the regulation of interstate telephony over the last two decades of that period was virtually nil:

> That USOA was a creature of its times, adapted to the regulatory and industry environment of the regulated monopoly era. Over the last two decades, as technical advances, the growth of competition, the proliferation of new products and services, and changes in industry structure dramatically altered that environment, the old USOA became obsolete.

<u>Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities</u>, CC Docket 86-111, 2 FCC Rcd 1298, 1300 (1987). In 1978, the FCC undertook to revise the old USOA; it was not until <u>ten years later</u> that the Commission was able to implement final rules.[60]

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[60] <u>Revision of the Uniform System of Accounts and Final Reporting Requirements for Class A and Class B Telephone Companies</u>, 60 Rad. Reg. 2d 1111 (1987). Even there, USOA's success is largely a result of a far more extensive undertaking instituted by the Commission: the Automated Reporting and Management Information System (ARMIS). <u>Automated Reporting</u>
(continued...)

The struggle for costing methodologies for regulated telephone services fared no better. The issues can be traced back to 1961 with the commencement of the original AT&T TELPAK tariff investigation -- Docket No. 14251.[61] In 1965, the Commission instituted Docket No. 16258[62] as a general investigation into the rate levels and rate level relationships existing with respect to Bell's interstate services. In 1968, the FCC commenced Docket No. 18128 to fully review the validity of alternative methodologies.[63] It took until 1976, fifteen years after the original TELPAK investigation, for the Commission to come to a final decision in Docket No. 18128. The 1976 decision only established findings as "basic cost of service principles and standards of general applicability."[64]

Thereafter, the Commission appointed a Cost Analysis Task Force to negotiate with the Bell System in preparing a Fully Distributed Cost Implementation Manual based upon the findings in

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[60](...continued)
Requirements for Certain Class A and Tier 1 Telephone Companies, 2 FCC Rcd 5770 (1987), recon., 3 FCC Rcd 6375 (1988). ARMIS established a computerized information reporting system, thus making the information contained in the USOA more readily accessible. Without ARMIS, USOA would be considerably less useful.

[61] TELPAK, Memorandum Opinion and Order, FCC 61-1039 (Sept. 7, 1961).

[62] AT&T and Bell System Companies Charges for Interstate and Foreign Communication Service, 2 FCC 2d 871 (1965).

[63] TELPAK, Memorandum Opinion and Order, FCC 68-388 (April 12, 1968).

[64] TELPAK, Memorandum Opinion and Order, 61 FCC 2d 587 (1976).

Docket No. 18128.[65] Then, the Commission, in the Fall of 1979, instituted CC Docket No. 79-245 to attempt to actually adopt a cost allocation manual for AT&T consistent with Docket Nos. 18128 and 20814.[66] In January 1981, the Commission finally adopted an Interim Cost Allocation Manual (ICAM).[67] The Commission's first officially adopted cost allocation manual was for AT&T, twenty years after the initial proceeding.[68] As the Commission stated in eloquent understatement:

> [T]he history of attempts to establish and implement cost allocation principles and procedures [for AT&T] has been a lengthy and complex one.[69]

Ironically, the ICAM requirement for AT&T was completely eliminated in 1989 as no longer relevant to price-cap regulated companies.[70]

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[65] See Revisions of FDC Costing Methodologies Subsequent to Docket 18128, FCC 77-110 (released Feb. 14, 1977).

[66] See AT&T Manual and Procedures for the Allocation of Costs, Notice of Inquiry, 73 FCC 2d 629 (1979).

[67] AT&T Manual and Procedures for the Allocation of Costs, Report and Order, 84 FCC 2d 384 (1981).

[68] Although AT&T developed and used several cost manuals before the issuance of the Order in CC Docket No. 79-245, none of the manuals was approved by the Commission. See AT&T Manual and Procedures for the Allocation of Costs, Reconsideration Order, 86 FCC 2d 667, 667-68 (1981).

[69] AT&T Manual and Procedures for the Allocation of Costs, Notice of Proposed Rulemaking, 78 FCC 2d 1296, 1306 (1980).

[70] See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, 3136-37 (1989).

The history of the Commission's efforts to develop cost allocation rules to separate regulated from unregulated activities is almost as tortuous. Its somewhat shorter timeframe is owed mostly to the fact that the Bell System was legally precluded from engaging in any unregulated activity other than manufacturing by operation of the 1956 Consent Decree. Once the FCC began to consider the Bell System's entry into vertical services, it found that accounting rules alone could not sufficiently protect ratepayers from the cross-subsidization incentives created by cost-of-service regulation. Thus, in addition to accounting requirements, the Commission ordered structural separation between regulated and unregulated activities.

As the structural separation rules were increasingly relaxed, the FCC struggled to adopt additional accounting rules in their place.[71] Each activity raised new issues, in which the agency took "an ad hoc, case-by-case approach to the regulatory oversight of allocation of common costs between regulated and unregulated activities." Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities, 104 FCC

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[71] See, generally, Computer II Order, 77 FCC 2d 384 (1980); Computer II Recon., 84 FCC 2d 80 (1980); Computer II Further Recon., 88 FCC 2d 512 (1981); General Departments Order, 90 FCC 2d 184 (1982); Shared Services Order, 92 FCC 2d 676 (1982); BOC Separation Order, 95 FCC 2d 1117 (1993); Joint Cost Notice, 104 FCC 2d 59 (1986); Joint Cost Order, 2 FCC Rcd 1298 (1987); Joint Cost Recon., 2 FCC Rcd 6283 (1987); Joint Cost Further Recon., 3 FCC Rcd 6701 (1988). The history is recounted in full in the Notice of Proposed Rulemaking in CC Docket No. 86-111, Joint Cost Order, 104 FCC 2d 59, 69-77 (1986).

2d at 77. "This case-by-case, reactive approach was appropriate, perhaps even necessary, given our initial lack of experience with accounting for nonregulated activities." Id. Agency approval of the cost allocation manuals and methods prescribed for the Bell Operating Companies was not completed until 1988. And the Commission has now been promising for years, but has not yet even begun, to promulgate cost allocation rules for telco provision of video dial-tone services.[72]

It is simply beyond reason for the Commission to now expect to replicate that history for the cable industry within a few months. The Commission has no experience in regulating cable system rates, and it has virtually no record upon which to make the complex, reasoned judgments called for in establishing cost accounting rules. The necessity of proceeding exclusively on a case-by-case basis could not be clearer.

C. MSO-Wide Averaging Is Unworkable.

The proposal to average costs for all franchises, and all systems owned by an MSO, sabotages the safety net function for cost-of-service. Cable companies are not telephone companies. The homogeneity of the telephone industry, with its technically and economically integrated features, may permit this. Indeed, when the Bell System divestiture was ordered, intending to divest the local exchange business from the interexchange business, that fine a division proved to be

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[72] Telephone Company - Cable Television Cross-Ownership Rules, Sections 63.54 - 63.58, 7 FCC Rcd 300 (1991).

impossible precisely because of the integrated nature of telephone operations. Instead, the artificial construct of "LATAs" was developed and superimposed upon the industry to approximate a division of monopoly from competitive services.

The analogy for the cable industry has very modest relevance. While the legal construct of "community units" may ignore the technical integration among these units within a single cable system, even for these limited purposes very different regulatory requirements may be imposed and very different costs and prices may result. In any event, once one reviews the industry on a system-by-system basis, no averaging can be justified. TCI-owned systems vary widely one to another. TCI systems may be as small as 300 subscribers; others may serve as many as 321,000 subscribers. Plant and technology can also differ within each franchise; some permit full addressability, for example, and others have no addressable capability. Some deploy fiber extensively, others have not required upgrading since their construction 10-15 years ago. TCI's cable systems' costs vary broadly for a variety of other reasons: population density, penetration rates, climate (which can require special plant features and configurations), topography, labor costs, demographics, etc. MSO-wide averaging would force inefficient pricing for cable services, forcing subscribers on low-cost systems to pay for costs actually incurred to serve subscribers in high cost areas. It would work further inefficiencies, as demand would be artificially distorted. Averaging company-wide would serve only one function, to make implementation administratively simpler. But there is little reason to believe that such averaging would be superior to even random selection.

D. Affiliate Transaction Rules Should be Promulgated for Cost-of-Service Hearings and to Remedy the Deficiency of the Price Cap Limitations.

The Notice proposes that affiliate transactions be subject to special accounting rules to ensure that cable companies electing cost-of-service hearings do not attempt to impute unregulated costs to regulated services. Where the unregulated affiliate is the supplier, the Notice proposes either a fair market value (as established by transactions with third parties) or the lower of book value or estimated fair market value. Where the regulated cable company is the supplier, the Commission proposes either established fair market value, or the higher of book cost or estimated market value. Notice at ¶¶ 67-69.

The Notice expressly proposes that these rules apply to programming supply contracts, and further proposes to utilize the standards developed in this proceeding as an alternative to, or substitute for, the current limited pass-through treatment of such costs for the cable price cap adjustment. Notice at ¶ 67, n. 70. The Rate Order provides for an express limitation on the pass-throughs permitted for programming services affiliated with cable MSOs.[73] Pass-throughs for increases in the rates of

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[73] Rate Order at ¶ 252. An affiliated programmer is defined as a programmer with an ownership interest of 5 percent or more.

affiliated programmers are limited to the annual incremental percentage increase or the GNP-PI, whichever is less.[74] Petitions for Reconsideration are pending on this issue, with persuasive showings that this limitation potentially decreases programming quality, and that it is contrary to analogous FCC treatment of affiliated transactions for telephone companies. Given that a general rule is required for both benchmark and cost-of-service implementation, TCI supports the Notice's proposal in this regard.

The fact that affiliated cable networks sell to thousands of third parties (including other MSOs and cable competitors) eliminates the feared opportunity for affiliated MSOs to manipulate regulated rates to subscribers. The use of sales prices to third parties as a market test for affiliate transactions has already been adopted by the Commission as a sufficient safeguard for telephony. The Commission thus has allowed telephone companies to book the entire cost of services purchased through affiliated entities as long as the affiliated entity makes sales to third parties.[75] In Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities,[76] the Commission ruled that services provided by an unregulated telephone company affiliate to the regulated telephone company are deemed reasonable, and may be recorded in

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[74] Id.

[75] See 47 C.F.R. 32.27(d).

[76] 2 FCC Rcd 1298 (1987).

the regulated firm's books at the price paid if that price reflects the same prices charged by the affiliate/supplier to third parties.[77] The Commission's rationale was that unregulated telephone company affiliates sales to third parties "provided reasonable assurance that the price of assets transferred would not be manipulated to the detriment of ratepayers."[78]

The Commission should afford similar treatment to affiliated cable programming networks because all affiliated programmers offer and sell their products to third parties. The more relaxed treatment given to telephone companies is appropriate for cable operators since an effective and market driven condition exists for programming services. Further, the cable operators should be afforded this relaxed treatment for the non-programming services as these relationships have historically encouraged cable operators to "buy in bulk" for equipment, thereby saving the subscriber otherwise unattainable reductions.

VI. THE COMMISSION SHOULD COMMENCE A PROCEEDING TO DEVELOP FEDERAL COST STANDARDS FOR REGULATED SUBSCRIBER EQUIPMENT

The instant Notice proposes to promulgate federal standards by which equipment cost regulation would occur. Cable subscriber equipment is one area that would permit an industry-wide approach to regulation as an option available to cable

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[77] Id. at 1336.

[78] Reconsideration of Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities, 2 FCC Rcd. 6283, 6293 (1987).

systems. TCI strongly urges the Commission to adopt this proposal as an option available not only for cable companies electing cost-of-service hearings, but also for those cable companies regulated under the benchmark approach. Thus, cable operators could opt for FCC-established price ranges, or for the calculations required by Form 393's worksheets.

The Commission's current rate regulatory scheme stretches the statute to permit each franchising authority to regulate, on a cost-based scheme, virtually all pieces of equipment used by cable subscribers to receive programming. Petitions for reconsideration are pending urging the Commission to modify aspects of the Commission's decision, most especially the categories of equipment, on both legal and policy grounds. Continuation of the current structure, which requires every franchising jurisdiction and every cable company subject to regulation to replicate a common effort, has severely adverse administrative and policy implications.

There are several reasons why the Commission should promulgate Federal standards. First, Congress has already mandated a cost-based approach for certain subscriber equipment for the entire industry. Second, averaging is justified given the homogeneity of the equipment. Subscriber equipment is manufactured and supplied on a national, indeed international basis. Local or specialized modifications to this general supply are rare and impose very little additional costs. While rates-of-return will vary, using an average here can be justified because it is permissive but not mandatory.[79] Third, the FCC has sharply limited the amount of overhead costs that can be allocated to equipment, minimizing annoying problems here as well. These factors combine to warrant a federally-established range of reasonable rates for categories of equipment.

In contrast, a scheme that requires individual jurisdictions to develop cost data separately is needlessly costly and inefficient. It invokes unnecessary duplication of effort by both the regulators and the regulated industry. Further, it will likely produce inefficient, controversial outcomes. As a practical matter, this likely means that the Commission will in any event establish national rates for equipment, through the appeals process as cable operators appeal decisions on equipment issued by their local regulators, or as cable programming service subscribers complain to the Commission about equipment rates. Admittedly, the implementation of rate regulation on September 1, 1993, will already have caused calculations to be made. However, it can be readily expected that disputes over these calculations will arise across the country. The establishment of ranges of reasonable rates by the FCC could generically resolve many of these disputes, and will further avoid the costs incurred by each franchisee and

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[79] Where a cable company's equipment costs depart materially from the average due to capital costs, an adjustment would be required. In this regard, the 11.25% rate of return assumed in the Rate Regulation Order is arbitrary, and requires reconsideration. See, e.g., Petitions for Reconsideration filed on June 21, 1993 by NCTA at 29-30 and Booth American Co., et al. at 25-28.

franchisor calculating equipment rates on an annual basis in the future. The Commission could materially minimize future administrative costs (private and public) through a general proceeding to set national ranges of equipment rates.

In addition to the administrative costs, the FCC must also concern itself with the indirect costs. The cable industry is about to commence the introduction of various types of customer equipment with myriad new functions and capabilities. Overreaching regulation will thwart the development and introduction of innovative equipment.

Federal regulation of equipment would give the FCC the opportunity to ensure a benign regulatory environment for new equipment offerings. Notwithstanding the desire to wholly unbundle services from equipment, and presumptively, the source of monopoly power from products actually or potentially subject to competition, cable services and equipment are indeed interdependent goods. Unbundling may be a valid policy, but it necessarily will disrupt, if not destroy, efficiencies.

In the case of basic cable services (the fundamental source of the perceived monopoly of the cable industry) Congress made a decision to forego those efficiencies. But no such decision was made in the context of cable programming services, and certainly no consideration was given forward-looking to digital compression technologies and the equipment necessary to derive additional consumer choice. To the extent Congress dealt with the issue abstractly, it made clear its preference for more consumer choice and advanced technology deployment. The current regulatory structure, however, takes the cable industry and its technologies as a static state -- and it does so at perhaps the industry's most dynamic period. Thus, if regulation is to occur at all for new types of equipment,[80] it should occur at the federal level where regulatory uncertainty and overreaching may be minimized.

VII. GIVEN THE COMPLEXITIES AND INEFFICIENCIES OF COST-OF-SERVICE REGULATION, THE COMMISSION SHOULD CONSIDER STREAMLINED ALTERNATIVES

The Notice also seeks ways in which the Commission could streamline rate regulation of cable companies in light of the well-accepted costs that inhere in traditional cost-of-service regulation. As TCI has explained throughout these

[80] Indeed, TCI believes that such new equipment, like digital compression boxes, should not be regulated on a cost basis. Cable operators introducing digital compression in order to offer consumers multiples of the numbers of signals they now receive through their cable system have no incentive to overprice the offerings of the compression boxes. Indeed, given the high risk, high cost nature of the first generation of these boxes, cable companies need to underprice the cost of the boxes to the consumer, ultimately recovering the remainder of the total costs through programming. Moreover, the services that will support this strategy will be those unregulated by the Act -- programming offered on a pay channel or pay-per-view basis.

As written, however, the rules provide substantial disincentive to introducing these kinds of equipment. These disincentives would prompt cable operators to adapt in three possible ways: to sharply limit or abandon the venture altogether; to require all cable subscribers to take the most expensive equipment with features they pay for but do not necessarily want; or to require those subscribers interested in the new services to lease or purchase two discrete kinds of converter boxes. None of these results serves consumers or the competitive marketplace ultimately envisioned.

comments, there are no good shortcuts to this process. Thus, the concept of streamlining rate-of-return regulation is an illusory one. However, TCI supports those aspects of the Notice that would permit alternative showings by cable operators as opportunities to justify rates that exceed the benchmarks.

The principal problem with the competitive benchmarks derived in the Rate Order is one of averaging. The industry-wide benchmarks do not adequately account for high-cost systems; indeed, the benchmarks do not really take costs into account at all.

The Commission could address this problem directly, as proposed in the Notice, by permitting "high cost" factors to be used to justify rates in excess of the benchmarks.[81] As Drs. Besen and Woodbury point out, there are a large number of factors that could account for large cost differences among systems including, for example: (1) churn rates; (2) density; (3) topography; (4) climate; (5) labor costs; (6) energy costs; and (7) cost-of-capital. Besen and Woodbury at 18-21.

TCI's own experience with a wide variety of systems reveals these and other factors to account for higher than average costs for some systems. Again by way of example, when TCI acquired a particular system in 1991, that system had several

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[81] High cost telephone companies receive an additional expense allocation for study areas in which the total intrastate and interstate loop cost exceeds the national average by 115 percent or more. See Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, 96 FCC 2d 781, 791-802 (1984)

different types of converters in subscribers' homes, making the system technically and economically inefficient to operate. The cost of rectifying this problem also proved to be substantial, given the need to changeout non-obsolete equipment, including the transactional costs involved in persuading subscribers that the system as a whole would fare better with uniform, compatible equipment.

As Drs. Besen and Woodbury explain in their attached paper, a full-blown cost-of-service proceeding will, in most cases, be unnecessary to account for high cost factors. Instead of focusing on "a whole host of issues, many of which would be irrelevant in more focused inquiries," the Commission should examine only those costs that "are the basis of a cable operator's request that it should be permitted to charge rates that are higher than the benchmark." Besen and Woodbury at 14. Cost-of-service regulation, with all of its inherent inefficiencies and administrative burdens, should not be utilized when other options are far better suited to the task at hand.

TCI supports the "streamlined" proposal in the Notice to "permit cable operators to document key cost factors, financial characteristics, or other combinations of factors that could be said to justify existing rates." Notice at 72. As Drs. Besen and Woodbury explain, this alternative "is more consistent with the Commission's stated objectives for its regulatory backstop, more workable administratively, and more likely to promote the public interest than is rate of return regulation." Besen and Woodbury at 16.[82]

VIII. THE COMMISSION SHOULD NOT AND CANNOT DEPLOY A PRODUCTIVITY OFFSET FOR THE CABLE INDUSTRY.

The Commission solicits comment on whether there is a valid basis for assuming that cable service has been, and will be, experiencing sufficient efficiency gains to justify a productivity offset.[83] The Commission sets out four options for commenters to examine, including no productivity offset, a "consumer productivity dividend," wholesale adoption of the telco productivity offset, and a unique, unquantified offset for cable companies.[84]

The proposal is yet one more example of the anomalies worked by simply borrowing telco regulation as a means of regulating cable companies. The adoption of a productivity offset for telcos was ordered by the FCC for two principal reasons: (1) the Commission had hard, substantiated data showing that the productivity gains of the telephone industry significantly exceeded economy-wide productivity gains; and (2) the transition from rate-of-return regulation to price caps was

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[82] In their attachment, Drs. Besen and Woodbury explain how this "streamlined" approach could be implemented by establishing a reference point for comparison, identifying factors that contribute to high costs, and permitting "add-ons" to the benchmark rate based on these factors. See Besen and Woodbury at 16-26.

[83] Notice at ¶¶ 81-85.

[84] Id. at ¶ 85.

likely to create windfalls to telco shareholders as distortions from the former were minimized. Neither of these factors is present here.

First, the Commission has no facts in this record for assuming that cable companies' productivity growth departs materially from that of the economy as a whole. In contrast, when the Commission considered the issue for telco companies, there was hard evidence establishing that telco productivity gains were substantially greater than economy-wide gains. The Commission was in possession of, and commenters were able to critique in several rounds of comment and reply, multiple studies quantifying the productivity of AT&T and the LECs.[85] This list included several comprehensive studies completed before the

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[85] See, e.g., Testimony of L. Christensen filed in United States v. AT&T, Civ. Action No. 74-1698 (filed D.D.C. 1974) (measured total factor productivity for the Bell System for the years 1947-78); AT&T, Bell System Productivity Study 1947-78 (Nov. 1979); M.I. Nadiri & M. Schankerman, The Structure of Production, Technological Change, and the Rate of Growth of Total Factor in the U.S. Bell System, Productivity Measurement In Regulated Industries (T. Cowing & R. Stevenson eds. 1981); M. Denny, M. Fuss & L. Waverman, The Measurement of Total Factor Productivity in Regulated Industries, with an Application to Canadian Telecommunications, Productivity Measurement In Regulated Industries (T. Cowing & R. Stevenson eds. 1981); American Productivity and Quality Center, Multiple Input Productivity Indices; Bureau of Labor Statistics, CPI Sub-Index for Telephone Service 1935-85; J. Kendrick, Improving Company Productivity 87, 102 (1984); Bellcore, The Impact of Federal Price Cap Regulation on Interstate Toll Customers (Mar. 17, 1988); J. Frentrup & M. Uretsky, A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity, 5 FCC Rcd 2176 (Appx. C) (1990); T. Spavins & J. Lande, Total Telephone Productivity in the Pre- and Post-Divestiture Periods, 5 FCC Rcd 2176 (Appx. D) (1990).